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THE BALANCE-OF-PAYMENTS PROBLEMS OF A EUROPEAN FREE-TRADE AREA[1]

I DO not propose in this lecture to inquire into the effect of the institution of a free-trade area in Western Europe upon productivity, standards of living and so on. I propose only to raise some of the financial issues which are involved. Is it possible in Western Europe to combine free trade with full employment and balance-of-payments equilibrium?

Balance-of-payments problems as between the members of a European free-trade area can be avoided if each member takes steps to keep its own overall balance of payments in equilibrium. It will not matter if France, for example, is in deficit with the rest of the free-trade area provided she is in overall balance, *i.e.*, in equal surplus with outside countries. She can then use the outside currencies which she earns to pay her debts within the free-trade area. And these outside currencies will be needed by the other members of the free-trade area; for if France is in deficit inside the free-trade area, some other member or members (say, Germany) must be in equal surplus within the free-trade area. But if Germany is also in overall balance, then the German surplus in the free-trade area must be matched by an equal German deficit with outside countries. If France has no overall deficit on her balance of payments, she can pay Germany with her earnings of outside currencies; and if Germany has no overall surplus on her balance of payments, she will need these outside currencies to pay her debts to the outside world.

This multilateral principle is well illustrated by the history of Benelux. Within Benelux the natural structure of trade and other transactions is such that the Netherlands is practically always in bilateral deficit with the Belgium–Luxembourg Economic Union. In the early post-war years the Dutch balance of payments was in overall deficit; and in these conditions the finance of her bilateral deficit with Belgium gave rise to problems which could be solved only by restricting Dutch imports from her partner. But from 1951 onwards the Dutch international payments regained an overall balance; and the Dutch were earning a surplus with outside countries which matched their deficit with the Belgium–Luxembourg Economic

[1] Presidential Address to Section F of the British Association, delivered on September 5th, 1957 at Dublin.

Union. The Dutch could pay the Belgians with the currencies of third countries.

Consideration of the payments problems of Benelux suggests that the maintenance of overall equilibrium in the balance of payments of each partner country is not merely a possible, but also the only acceptable, method of dealing with payments between the partners. Consider the alternative principle that each partner should keep its payments with the other members of the union (rather than with all the other countries of the world) in balance. This result could be achieved in Benelux without restrictions on intra-Benelux trade if there were a very great rise in Belgian prices and costs (brought about by inflation in Belgium or by an appreciation of the Belgian franc) so as to cause an increase in Belgian purchases from, and a decrease in Belgian sales to, the Dutch on a sufficient scale to bring the bilateral Belgian–Dutch balance of payments into equilibrium. But this would have threatened to put the Belgian overall balance of payments into serious deficit, since the rise in Belgian prices and costs would have increased Belgian imports from, and would have decreased her exports to, the rest of the world as well. Belgium would have had to impose strict controls over payments to other countries. Or if the Dutch–Belgian balance of payments were put into bilateral balance by such a deflation in the Netherlands as to reduce Dutch purchases from, and to increase Dutch sales to, Belgium to the required extent, then this would have caused a great decrease in Dutch imports from, and an increase in Dutch exports to, the outside world as well. The Dutch would have to deal with a large undesired surplus in their overall balance of payments.[1] In conditions in which the structure of trade and payments is such that some members of a free-trade area naturally have deficits with their partners matched by surpluses with outside countries, while other members are in the opposite situation, the principle that each member should be primarily concerned with its overall balance of payments is the only acceptable one.

Our first and basic principle is, therefore, that each member of the free-trade area should maintain equilibrium in its overall balance of payments. But before proceeding further I would like to make two comments on this general principle.

First, the maintenance of overall equilibrium in a country's balance of payments is nothing like so precise a criterion as might at first sight appear. Obviously, since some countries will naturally and properly be lending

[1] Suppose that the Netherlands were in overall surplus (its deficit with Belgium being less than its surplus with the outside world), while Belgium were in overall deficit (her surplus with the Netherlands being less than her deficit with the outside world). Suppose then that the Dutch inflate and the Belgians deflate. The Dutch will get rid of their overall surplus by decreasing their surplus with the outside world but *increasing their deficit with Belgium*, while the Belgians will get rid of their overall deficit by decreasing their deficit with the outside world and *increasing their surplus with the Netherlands*. The solution of a balance-of-payments problem of a free-trade area may thus well involve the increase of the deficits and surpluses within the area itself.

abroad or borrowing from abroad for ordinary commercial and developmental purposes, by equilibrium in the balance of payments we do not mean an equality between current payments and current receipts. We are concerned with the balance of all normal current and capital payments and receipts. Even so, we cannot make an exact equality between payments and receipts our criterion. A country which has very inadequate reserves of gold and dollars may properly aim at some surplus of normal receipts over payments which will enable it to bring its reserves to a reasonable level. We can only lay down a general principle that it is the duty of each member of the free-trade area to avoid a continuing deficit or surplus on its overall balance of payments which threatens to result in the unreasonable accumulation or loss of its reserves.

Second, we must allow for the fact that not all outside currencies are convertible into each other. To return to my Benelux example, suppose that the Netherlands and Belgium are both in overall equilibrium, but that the Belgians have a deficit with the outside world and a surplus with the Netherlands, while the Dutch have a deficit with Belgium but a surplus with the outside world. If the outside currency which the Dutch are earning is a " hard " currency which is convertible into the outside currency which the Belgians are spending, all is well. The Dutch can pay the Belgians with this currency, and the Belgians can use it to finance their outside debts.

But trouble might arise if Benelux as a whole, while it is in overall balance, has an outside surplus of " soft " currencies and an outside deficit of " hard " currencies. The Netherlands might be earning a surplus of outside " soft " currencies which were not convertible into the " hard " currencies needed by Belgium for the finance of her outside deficit.

There are in fact two very different types of case in which a European free-trade area as a whole might be earning a surplus of " soft " currencies.

In the first case the surplus earnings of the free-trade area may be in terms of a currency which is not freely convertible into other outside currencies but is more or less freely convertible into the currency of one of the members of the free-trade area. The outstanding example of this is, of course, the overseas members of the sterling area. Suppose that in the European free-trade area the Germans have a dollar deficit and that the French are in debt to the Germans but are earning a surplus in Australian pounds, which are freely convertible into United Kingdom pounds, the United Kingdom being a member and Australia not a member of the free-trade area. If sterling is not freely convertible into dollars, the French cannot pay the Germans in an outside currency which the Germans need. The basic cure in this type of case is, of course, that the sterling area as a whole, rather than just the United Kingdom, should be in overall balance. If the free-trade area (excluding the United Kingdom) has a surplus with the sterling area, then the sterling area (including the United Kingdom)

will be in overall balance only if it has a surplus with some country outside the free-trade area and the sterling area, *e.g.*, with the dollar world. Once again the circle is closed. France can pay Germany with her sterling earnings and, since the sterling area has a dollar surplus, Germany can convert this sterling into dollars for the finance of her dollar deficit without putting a strain on the sterling area's dollar reserves.

The basic balance-of-payments rule for the free-trade area must thus be modified to the effect that each national government undertakes to maintain overall equilibrium in the balance of payments of the monetary area of which it is the centre rather than merely overall equilibrium in its own national balance of payments. This puts the United Kingdom in a special position which has become a familiar problem in the European Payments Union and the Organisation for European Economic Co-operation. The United Kingdom, as banker for the sterling area, has cleared all sterling-area payments through E.P.U., but in the adjustment of the O.E.E.C. trade liberalisation programme to maintain balance-of-payments equilibrium she has been able to enter into commercial-policy commitments only for the United Kingdom and not for the other members of the sterling area such as Australia.

A different type of problem might arise if the outside deficits of the free-trade area were in dollars and the outside surpluses were in some currency like the Brazilian cruzeiro, which is convertible neither into other outside currencies (such as the dollar) nor into the currency of a member country (such as sterling). But the countries of Western Europe are now in a sufficiently strong position to deal with this type of problem in a simple but decisive manner. If the monetary authority of each European country does not undertake to exchange into its own European currency any Brazilian cruzeiros which its exporters may earn, then in self-defence the individual European exporters to Brazil will demand from the Brazilian importers to be paid in their own European currencies or in other acceptable convertible currencies. This means that the Brazilian authorities have to take steps to see that their importers do not purchase more from Western Europe as a whole than Brazil can finance out of the proceeds of her exports or other earnings. Immediately after the War each country of Europe dealt with this problem by a separate bilateral payments arrangement with Brazil or with similar "soft" currency countries. This is now unnecessary; and, through the so-called Hague Club, arrangements are now being made whereby the Brazilians can transfer any earnings which they may obtain in one European currency into another European currency for the purchase of goods from that second European country. In these conditions while one European country alone may have an excess of exports to Brazil and another an excess of imports from Brazil, there can be no problem of an excess of earnings of the "soft" Brazilian currency by the free-trade area as a whole.

But let me return to my main problem. By what means can each member of the free-trade area keep its overall balance of payments in equilibrium? There are at least five possible lines of approach to this problem which I shall call the liquidity approach, the gold-standard approach, the integration approach, the direct-control approach and the exchange-rate approach.

By the *liquidity approach* I mean that steps might be taken to increase the availability of liquid reserves to the European countries which are in overall deficit so that they can thereby tide over temporary balance-of-payments difficulties. This cannot, of course, provide a full cure for lasting and permanent balance-of-payment deficits. But it can deal with temporary balance-of-payments problems and, above all, it can provide a buffer which will enable other measures for dealing with permanent difficulties to have time to work out their effects. Reserves of some European countries and particularly of the United Kingdom are still lamentably low. An increase in liquidity is an essential ingredient in a satisfactory solution of our problem.

How can this best be achieved? One's thoughts naturally turn to the European Payments Union, which provides a mechanism whereby, according to the credit element in the monthly settlements, European countries with a surplus in their payments to other European countries automatically provide credit, and so liquidity, to those European countries which have a deficit in their payments with other European countries. Could the European liquidity problem be solved by a development of this European instrument whereby European surplus countries provide credits to European deficit countries?

There are two serious objections to reliance upon an E.P.U. type of mechanism.

In the first place there may well be times when the European free-trade area as a whole is in deficit with the outside world. This means that the overall deficits of the European deficit countries are greater than the overall surpluses of the European surplus countries. In such circumstances, it is impossible to cover the deficits of the deficit members by the surpluses of the surplus members. For this reason it would be much more satisfactory to proceed by means of a more " universal " approach (such as an extension of drawing rights with the International Monetary Fund) which would give each European country, regardless of the position of its European partners, greater international liquidity to deal with its own overall balance-of-payments problems.

If, however, this more " universal " approach is for any reason ruled out, it is possible to do something by methods whereby European surplus countries lend temporarily to European deficit countries. But there is now a second objection to an E.P.U. type of mechanism. My basic theme has been that if each member is in overall balance-of-payments equilibrium,

then the settlement of payments within the free-trade area should be possible. Suppose that the Netherlands has a dollar surplus matched by a deficit with Belgium, while Belgium has a dollar deficit matched by its surplus with the Netherlands; it should be possible for the Dutch to pay the Belgians with dollars. But with the E.P.U. arrangements the Netherlands will continuously pile up reserves of gold and dollars, since their surplus is earned wholly in that form, while their deficit is payable through the E.P.U. partly in book credit. But Belgium will run out of gold and dollar reserves, since her dollar deficit must be financed wholly in that form while her surplus is with E.P.U. and will be financed partly by a book credit with E.P.U. This difficulty is avoided if settlements through E.P.U. are 100% in gold; but in this case E.P.U. does not fulfil the function of providing additional credit by overall surplus to overall deficit members.

It is, of course, possible to devise methods for European surplus countries to lend to European deficit countries, which are not open to this objection. This might be done merely by arrangements between the exchange equalisation accounts or similar authorities of the members to the effect that the authorities of an overall surplus member would hold more of the currencies of an overall deficit member. Or it might be rather more institutionalised in the form of a European Monetary Fund into which all members paid certain amounts of their own currencies, and possibly also of their reserves of gold and dollars, and from which members with overall deficits were able to make temporary drawings. Or it might take the extreme form of the payment of all the gold and dollars of all the members into a common single pool, payments between members being financed by the transfer of claims on this pool, and payments to the outside world by drawings from the pool. This last system would, of course, have special implications for the United Kingdom, since it would mean pooling with the Europeans the reserves held against the claims of the whole Sterling Area; and although there is nothing inherently illogical (indeed there is much positively desirable) in extending the payments mechanism to cover a wider region than the commercial free-trade area, the political difficulties involved are obviously very great.

In any case an increase in international liquidity for European countries is not a complete cure for our problem. What methods could be used to deal with persistent balance-of-payments problems in the European free-trade area? Let us consider first what I have called the *gold-standard approach.*

By this I mean the application of the principles of the old gold standard as they are expounded in the text-books. Any member of the free-trade area which is in overall deficit will lose reserves of foreign exchange; it should allow this to lead to a restriction of the domestic supply of its money until its domestic money incomes, prices and costs are so deflated that it has put its overall balance of payments into equilibrium by buying less imports and supplying more and cheaper products for export. Simultaneously any

surplus member of the free-trade area should allow its receipt of foreign-exchange reserves to cause a monetary inflation domestically, which should lead to an increase in its imports and a decrease in its exports. This solution is dangerous. It requires that each European national government should devise its domestic monetary and budgetary policies essentially with regard to its balance-of-payments situation and with little or no thought for its domestic situation. Financial policies to prevent domestic inflations or to preserve full employment must be more or less abandoned.

This would mean that Germany, so long as she has an overall balance-of-payments surplus, must inflate her domestic money incomes, prices and costs. But Germany, with her memories of past hyper-inflation, is very unwilling to do this. And, as recent events show, a surplus country like Germany is always able to restrain an inflation; she can, through restrictive domestic monetary and budgetary policies, offset the domestic inflationary effects of a balance-of-payments surplus and continue to pile up balances of gold and foreign currencies. But this means that a potentially deficit member of the free-trade area such as France might have to make an undue share of the adjustment by a domestic deflation of its money incomes, prices and costs; for it cannot indefinitely postpone the adjustment, since its stock of gold and foreign currencies is limited and exhaustible. It might have to abandon a domestic financial policy of expansion for full employment just at the time that the structural adjustment of its industries due to the removal of trade barriers within the free-trade area may be causing some redundancy of labour in its less efficient industries, so that it was especially desirable to have a domestic background of financial expansion to ease the development of its more efficient industries. Governments are nowadays so wedded (and, in my opinion, rightly so wedded) to the idea that it is one of their duties to preserve full employment that the probable outcome of this solution would in fact be the breakdown of the free-trade-area arrangements.

Many who accept these criticisms of the gold-standard approach may ask whether we could not get rid of payments difficulties, at least within the free-trade area, by combining with the building of a free-trade area in Western Europe the integration of European financial arrangements so as to make it as easy for a Frenchman to pay a German within Europe as it is for a Welshman to pay an Englishman within the United Kingdom.

The logic of this *integration approach* is unassailable. But it is not, I think, always realised how far-reaching this proposal is. This we can best see by asking why it is that the adjustment of payments between England and Wales is so much easier than that between Germany and France. There are at least five elements to the answer.

In the first place, the fact that goods, labour and capital can move freely between England and Wales makes adjustment easier. Suppose Wales is in economic difficulty. A deflation of prices and incomes in Wales relatively to prices and incomes in England will have more effect in inducing

consumers to buy Welsh rather than English products and in inducing workers to work in England rather than Wales, because there are no restrictions on the movement of goods or workers from Wales to England. Moreover, any rise in interest rates in Wales caused by a scarcity of money capital due to the deflation of money supplies in Wales would have more effect in attracting new capital funds from England because there are no barriers to the movement of capital within the United Kingdom. Indeed, the Welsh and the English share in common the London capital market. A complete common market for goods, labour and capital throughout Western Europe would similarly make the mechanism of adjustment of payments easier. There is some truth in the contention that the gold-standard approach is less dangerous when it is applied to the payments between the members of an economic union than when it is applied to payments between national States which maintain impediments to the movement of goods and services between them.

But this is not the whole of the story. A second reason why the adjustment of payments between England and Wales is much easier than between Germany and France is because the United Kingdom has, while Western Europe has not, got a single common currency and banking system. If the Welsh balance of payments with England is £1 million in deficit, then this means that £1 million of currency or bank deposits passes from the ownership of Welshmen to that of Englishmen. This deflation of £1 million in Wales and inflation of £1 million in England is the end of the direct monetary adjustment. But if the French balance of payments with Germany is 1 million francs in deficit, then the French central bank loses 1 million francs of foreign-exchange reserves and the German central bank gains an equivalent amount of reserves. There are many reasons why a change of 1 million in a country's foreign-exchange reserves may cause a change of many millions in its total domestic supply of money. In particular, if France has only a small proportion of her total domestic supply of money covered by foreign-exchange reserves, she may have to deflate her domestic supply of money by many times any loss of her reserves, in order to prevent a dangerous fall in her foreign-exchange reserve ratio. In other words, the absence of a single money means that the abruptness and speed of adjustment in France and Germany may have to be much greater than in Wales and England. Much of this problem would, of course, be solved by sufficiently far-reaching arrangements for increasing international liquidity between the members of the European free-trade area. In the example just given, if France had foreign-exchange reserves equal to 100% of her domestic money supply, then any given loss of reserves would no longer make it necessary for her to deflate her domestic money supply by many times that loss of reserves.

Thirdly, England and Wales have a single national government which by the adoption of a stricter or easier central-banking monetary policy or by running a budget surplus or deficit can pump monetary purchasing

power out of or into the system as a whole. This means that there can be an effective anti-inflation or anti-deflation financial policy for the United Kingdom as a whole which can take into account the interest both of Wales and of England. Trouble with the Welsh balance of payments need not be intensified by a failure of monetary demand in England to expand sufficiently. This is a most far-reaching difference between interregional and international payments. In Europe at present it is the function of each national government by control of its central bank's monetary policy and through its own budgetary policy to prevent undesirable domestic inflations and deflations. Free trade combined with fixed exchange rates (the gold-standard approach) would prevent European governments from devising their domestic financial policy for the purpose of preserving domestic stability. But the prevention of widespread booms and slumps is an essential feature of modern government. To entrust this task to a supranational European authority would require a very far-reaching surrender of powers by the national governments to ensure a single central-bank policy and a single budgetary policy for Western Europe as a whole.

Fourthly, suppose that the balance-of-payments deficit of Wales is greater than the balance-of-payments surplus of England, so that the United Kingdom as a whole has a deficit with the outside world. There exist central authorities for the United Kingdom which will then do something to correct the United Kingdom balance of payments. Restrictions on imports into the United Kingdom as a whole would cause consumers in the surplus area, England, to purchase from the deficit area, Wales, goods which could no longer be procured from abroad. Similarly, a depreciation of the pound would cause outside goods to rise in price relatively to goods inside the United Kingdom, and England would buy more from Wales and less from outside countries and would sell more to outside countries and less to Wales. This also is a very far-reaching point. A European supranational authority with extensive governmental powers would be needed to devise and administer a single programme of control over imports into the free-trade area from outside (we shall return to this problem at a later stage) and to decide upon any changes in the exchange-rate between all European currencies, on the one hand, and all outside currencies, on the other.

Fifthly, if in the United Kingdom (in spite of the factors which we have just mentioned) some economic adjustment does bring concentrated depression in a single region (like South Wales in the 1930s), then the central government in London exists to take special measures to bring new investment and enterprise to South Wales and to help to move labour out of South Wales. No such supranational authority exists to take such " special-area " action on the part of Western Europe as a whole for the promotion of economic development in, say, a particular region of Europe, like Southern Italy.

The integration approach thus involves—in addition to the formation

of a common market for goods and for factors of production and the provision of much greater international liquidity for European monetary authorities—a very extensive range of powers for what would amount to a single European government. Such a government would have to be able to control central-bank monetary policy and governmental budgetary policy throughout Europe, to determine a single European commercial and exchange-rate policy *vis-à-vis* third countries, and to carry out an effective special-area policy for depressed regions in Europe.

This is in my opinion ultimately desirable; let us hope that it will prove ultimately practicable; but it is not a starter at the moment, and it would be a great shame to sacrifice the present real political possibilities of building a commercial free-trade area to this ideal of simultaneous monetary and budgetary integration.

Let us consider next the possibility of dealing with a deficit in a country's balance of payments by imposing restrictions on imports from abroad or on payments to other countries. This *direct-control approach* is more desirable than sole reliance on the gold-standard approach, with its potential threat to full employment; and it is more practicable than the integration approach with its very far-reaching political implications. But in so far as it involves a deficit member of the European free-trade area restricting imports from another member of that area, it cuts deeply into the idea of a true free-trade area. Its interference with the free-trade principle is not to be measured merely by the amount of restriction of imports which actually exists at any one moment of time. The mere knowledge that trade may be restricted in this way in the future will discourage the large-scale investments that may be necessary to build up localised specialised mass production for the whole European market. The mass production of motor cars in Detroit in the United States involves the investment of huge sums of capital in plant and equipment in Detroit, which is undertaken because the producer knows for certain that the whole United States market will always be freely open to him.

If restrictions on trade between the members of a European free-trade area are to be avoided, it must, of course, be possible for traders to make payments for such purposes. This does not in itself imply the absence of all exchange controls over the currencies of the countries concerned. Thus any one member country, say France, could maintain strict exchange controls; every Frenchman who wanted a foreign currency, say, German marks, to purchase goods from Germany, might be required to obtain the currency from a central French exchange-control authority or its agent; and every Frenchman who acquired any foreign currency, say, German marks from the sale of French products to Germany, might be required to surrender the currency to the central French exchange-control authority or its agent in exchange for francs. All that is necessary to ensure the free entry of German products into France is that the French exchange-control

authority should in fact always grant a Frenchman's request for foreign currency if he can show that it is required to finance the import of German products into France.

But the problem is very different if it is intended that there should be freedom of capital movements between the member countries. Full freedom of movement of capital funds from France to Germany, for example, means that the Frenchman must be free to buy German marks for all purposes, capital as well as current. But suppose that the German exchange control differs from the French, the French forbidding and the German allowing the movement of capital funds into dollars. If the Frenchman is free to lend to the German, and the German is then free to lend to the American, it does not require great ingenuity on the part of financiers (who are not conspicuously lacking in that quality) to devise means whereby in effect the Frenchman is lending his money to the American by way of a German intermediary. The control of the movement of capital from France to the United States will become much less effective if there is freedom of movement of capital funds from France to Germany and the German mark is fully convertible. To make one member's control over exports of capital to countries outside the free-trade area effective, the exchange-control regulations of all the members must be harmonised, if freedom of capital movement within the free-trade area is to be maintained. This is a very difficult operation. If it should prove too difficult, then freedom of movement of capital funds cannot be allowed in Europe so long as some members are in heavy deficit and need to control the outflow of capital at least to the outside world, while others are in strong surplus and wish to make their currencies convertible into outside currencies.

But let us return to the problem of trade controls. Is it possible for a member of the European free-trade area to deal with a deficit in its overall balance of payments by restricting imports from outside countries without restricting imports from the other members of the free-trade area? [1]

The use by the members of the European free-trade area on balance-of-payments grounds of restrictions on imports from third countries can be organised in either of two ways which I will call the *national* and the *supra-national* methods respectively. By the national method I mean simply that each individual member of the free-trade area might restrict imports from outside countries into its own national market as an aid to the preservation of equilibrium in its own overall balance of payments. By the supra-national method I mean that the members of the free-trade area should set up some joint authority which would determine the total amount of outside goods which could be imported into the free-trade area as a whole, using this instrument to preserve equilibrium in the balance of payments of the area as a whole with the outside world.

[1] I do not propose to consider on this occasion which, if any, of the systems of import control discussed below would require a special waiver under the General Agreement on Tariffs and Trade.

There can, I think, be little doubt that in the circumstances of the European free-trade area it is the national method which must be employed, at least until there is some further movement towards extensive European integration. There is great difficulty in the supranational method. Suppose that Germany is in overall surplus and France in overall deficit, but that France's deficit is greater than Germany's surplus and the area as a whole is in deficit. To get a single joint programme of control of imports into the area from outside agreement has got to be reached on at least three basic points. First, how severe should the total restrictions be? Germany may want the problem solved mainly by deflation or depreciation by France with little common import restriction, and France may want it solved mainly by inflation or appreciation by Germany with much import restriction. With the supranational method this choice would have to be made by common agreement. Second, given the degree of total restriction, which particular imports should be restricted? France may want severe restrictions on the import of wheat which she produces, but not on chemicals which she does not produce; and Germany may want the opposite type of import programme. Thirdly, given the degree of restriction of each particular import, how many of the import licences should be given to German and how many to French importers? If we may draw any conclusions from the history of the Benelux economic union, we can safely conclude that the formation of a common programme of restriction of imports from third countries is one of the most difficult things to achieve even when there are only two trading partners to be considered.

Let us then consider the case of a member of the European free-trade area which is in an overall balance-of-payments deficit and which is trying to deal with this by restricting imports from outside countries without restricting imports from the other members of the free-trade area. In these conditions too much reliance cannot be placed upon the weapon of import control. In any free-trade area comprising the main countries of Western Europe each individual member would in fact purchase a large proportion of its total imports from other members of the area. In 1955 the United Kingdom purchased 28%, Western Germany 51%, France 33%, Italy 46%, the Belgium–Luxembourg Economic Union 59% and the Netherlands 59% of its imports from other countries of Western Europe. Import restrictions which were confined to imports from other sources would thus be limited in their scope.

Moreover, the limitation of this weapon is rather greater than these crude figures suggest. For the imports of the typical Western European country from outside Europe consist very largely of raw materials and foodstuffs which are less easily dispensable than many manufactured goods which it imports from its Western European partners.

There is a further reason why restrictions on imports from outside countries imposed on what I have called the national as opposed to the supra-

national principle may in certain circumstances prove a rather weak weapon of control. Suppose that France restricts imports of United States products because she is in deficit, but that Germany does not do so because she is in surplus. Then if United States products can move freely from Germany to France, the French restrictions become very ineffective. Indeed, for the system to have any sense at all it must be open to France to restrict the import of United States produce whether it comes into France directly or *via* Germany. But even if this is done, French restrictions on some United States products (say, motor cars) may mean that more such cars are imported into Germany, thereby releasing for export to France some German cars which would have been wanted in the German market if Germany had also been restricting the import of United States cars. The national method will, because of such substitutabilities, be somewhat less effective a device for causing a net reduction in total imports than the supranational method. France will have to rely rather more on disinflation or depreciation than would otherwise be the case, when France is in deficit and Germany in surplus.

But when all the members of the free-trade area are simultaneously in overall deficit, when—that is to say—the free-trade area is in deficit because the outside world is in surplus with all the individual members, then the national method will work very effectively. If Germany is restricting the import of United States cars because she (Germany) is in overall deficit, then the restrictions which France is putting on the import of United States cars will not be offset by the increased import of German cars which are being replaced by United States cars in the German market. If and when developments in the outside world (and, of course, in particular in the United States) impose an almost universal strain on European balances of payments, then the national method will automatically regain its full effectiveness. I personally regard the fact that it will be rather an ineffective tool, except in circumstances such as these, as a strong recommendation of it.

Because of the difficulties involved in operating the supranational method, even the six countries forming the full European customs union would probably have to operate their restrictions on imports from outside countries by the national method. They would then have to maintain a customs control at their common frontiers to prevent the products of outside countries from entering a member country with severe import restrictions indirectly *via* a member country with lax restrictions on the products of outside countries. But the experience of Benelux suggests that, unless they are successful not only in imposing a single tariff of duties on imports from outside countries, but also in unifying all domestic excise duties and turnover taxes and in removing all their domestic agricultural support policies, they will in any case have to maintain customs controls at their common frontier.

But whatever the members of the full customs union may do, the United

Kingdom must employ the national method for her restrictions on imports from outside countries. She will wish as far as possible to avoid discriminating against the products of Commonwealth countries, particularly if they are members of the sterling area; but if she joined in any common European supranational import-control plan, she might be forced to restrict imports from sterling-area-commonwealth countries, even though she had to admit similar European products without restriction.

Incidentally, because of this special relationship both to Europe and to the sterling-area countries the United Kingdom will find restrictions on imports from outside countries a particularly weak weapon. In 1955 the United Kingdom purchased 28% of her imports from Western Europe and 38% from the Sterling Area, leaving only 34% from other sources for restriction; and much of this 34% consists of basic materials and foodstuffs which it would be undesirable to restrict.

There remains the *exchange-rate approach* to the problem. A simple process of elimination leads inevitably to the conclusion that if the European national governments are going to use monetary and budgetary policies for purposes of domestic stabilisation—if, for example, in their present situation of balance-of-payments surplus the German authorities are nevertheless going to use their monetary policy to prevent a domestic inflation—and if it is desired to avoid the use of quantitative import restrictions on trade within the free-trade area, a greater use of the weapon of exchange-rate variations will have to be made. Some re-alignment of exchange rates may be particularly necessary during the initial stages of building the free-trade area. The removal of trade barriers of varying degrees of severity and the consequential development of import and export trades of varying degrees of expansibility may leave some members in deficit and others in surplus. The correction of this initial structural disturbance may require some exchange-rate adjustments quite apart from any need for exchange-rate variations to maintain equilibrium when once it has been achieved. Members of the free-trade area with a persistent surplus in their overall balance of payments will have to be ready to appreciate, and those with a persistent deficit will have to be ready to depreciate, the foreign-exchange values of their currencies.

This question is a difficult and controversial one, and it is not possible to discuss it at length in this lecture.[1] There are, of course, serious disadvantages in variations of exchange-rates. There is the possibility that anti-social speculative movements of funds will be generated by the expectation of depreciations. There is the danger that a depreciation by raising the price of imports and so the cost of living will itself cause a rise of wage-rates which, by making exports more costly, will give rise to yet a further depreciation.

[1] For my own views on the subject, see J. E. Meade, " The Case for Variable Exchange Rates," *The Three Banks Review*, September 1955.

These dangers will be much less if the European governments adopt effective domestic measures to prevent domestic inflations as well as to prevent domestic deflations. Speculation against a currency is most serious and dangerous when speculators think that a depreciation may set in motion the vicious inflationary spiral of higher import prices, higher wage-rates, higher money costs, more depreciation and so on without end. Exchange-rate variations are certainly not a substitute for sensible and effective domestic policies to prevent inflation; on the contrary, they can be expected to work only if they are accompanied by such domestic policies.

The governments of all the countries of Western Europe are nowadays technically and politically in a position to control the total money demand within their countries by means of suitable budgetary and banking policies. What is much less certain is their ability to cope with inflation arising on the side of costs. If the institutions for the fixing of wage-rates are such that, so long as there is reasonably full employment, money wage-rates are pushed up more quickly than output per head, the European governments will be faced by an unhappy dilemma: through their control over banking and budgetary policies either they must allow an increase in the total money demand for goods and services which will provide employment for all workers at the higher money wage-rates (in which case prices will rise as rapidly as costs) or else they must restrict monetary demand so as to prevent domestic purchasers from offering higher prices for the country's output (in which case higher money costs are likely to lead to unemployment). Only if suitable wage-fixing arrangements can be devised will the European governments be able to use their control over banking and budgetary policies in such a way as to combine full employment with sufficient stability of prices to reassure their own citizens and foreign holders of their money that it is not necessary perpetually to speculate against a further loss of value and depreciation of the national currency concerned.

This problem of control of inflation from the cost side as well as the demand side is perhaps the most important economic issue which now faces the governments of Europe. In present circumstances it can be tackled only on a national basis, since trade unions are national organisations and wage-fixing methods and habits vary widely from country to country. There are sure to be some divergences in its treatment; and differences in the annual percentage rate of change of prices and costs in different European countries, though very moderate in amount, could give rise to serious balance-of-payments problems as they accumulate at compound interest over a period of years. For this reason, if for no other, rates of exchange between the European currencies must be variable, if it is desired to avoid more or less permanent restrictions on imports from being used as the way of meeting a growing divergence in levels of prices and costs.

But while exchange-rate variations are a necessary weapon in the armoury, it is of the utmost importance that they should not be regarded

merely as another name for exchange-rate depreciations. Strong currencies should be expected to go up as much as weak currencies to go down. In order to establish this principle, it is especially important to initiate the use of this weapon in Europe with the appreciation of a strong currency rather than with the depreciation of a weak currency. There should probably be some depreciation of the French franc; but first and foremost at this moment there should be a substantial appreciation of the German mark.

I think that my attitude to exchange-rate variations is very much like Sir Winston Churchill's attitude to democracy, which he once described as the worst of all possible forms of government except the others. And I am reminded, too, that Mr. E. M. Forster once wrote a book entitled *Two Cheers for Democracy*, so I ask you to join with me in giving one cheer for a depreciation of the French franc and two cheers for an appreciation of the German mark.

I will conclude by outlining my own tentative conclusions on this difficult problem.

Full employment is more important than free trade for Europe; and financial policies to prevent booms and slumps must for some time remain primarily the function of the European national governments. In order to ensure that they could not be forced to abandon their full-employment policies on balance-of-payments grounds they should for the time being be able to restrict imports even from their partners in the free-trade area, until experience has shown that alternative balance-of-payments arrangements can be made to work. But such restrictions are a serious derogation of the principle of European free trade; they should be used only as a very last resort; and their imposition and use should be subject to the close supervision of an appropriate European authority.

A workable positive arrangement which would enable full employment to be maintained without restrictions on intra-European trade could meanwhile be worked out on the basis of three main principles. First, the European national governments must carry out effective domestic stabilisation policies, the surplus countries putting the emphasis on the avoidance of deflation, and the deficit countries on the avoidance of inflation. Second, the foreign-exchange values of the currencies of countries in a persistent balance-of-payments surplus must be appreciated and of those in a persistent balance-of-payments deficit must be depreciated. Thirdly, greater foreign-exchange reserves must be extended to the deficit countries to tide over the process of readjustment.

There are many ways of implementing these three general principles; but by way of illustration I will tentatively recommend one particular method.

As I have said, domestic monetary stabilisation would remain essentially the concern of the national governments; but something can be done to encourage suitable national action by international discussion and co-

operation. Each member of the free-trade area should formally recognise that its partners had a legitimate interest in the successful stabilisation of its own domestic incomes, prices and costs, and, in particular, in the avoidance of deflations by surplus members and of inflations by deficit members. There should be some European institution like the Organisation for European Economic Co-operation at which the national governments would regularly consult each other about their domestic financial policies.

Against a background of domestic stability the exchange rates of the national currencies of the members of the free-trade area should be allowed to float in a more or less free foreign-exchange market. This suggestion is liable to raise up a picture of wildly fluctuating European currencies, many of them losing their value completely. If reasonable domestic policies for domestic stabilisation are applied, nothing could be more absurd; and unless such policies can be applied, no sensible balance-of-payments policies for a true free-trade area can be devised. If reasonable domestic policies for domestic stabilisation are applied, there will still be some moderate external disturbances or some moderate divergences in price and cost levels requiring adjustment. To meet these, exchange rates will float moderately upwards or downwards; and every encouragement should be given for the development of a free market in forward exchange, so that the moderate inconveniences and uncertainties for traders resulting from these moderate fluctuations in exchange-rates may be minimised.

In such circumstances there should be no essential difficulty for the countries of continental Europe in allowing their exchange rates to float. There would be more difficulty in the case of sterling, which is a currency used extensively by traders in other countries, held in large amounts by residents in other countries, and backed by inadequate reserves. There are, therefore, much greater possibilities of speculation by non-resident holders against sterling than against other currencies. But this is a difference of degree rather than of kind. It means that it is more important for the United Kingdom to obtain greater reserves or a greater degree of international liquidity by one means or another; and it means that it is especially important for the United Kingdom to devise an effective domestic policy for the avoidance of inflation from the cost as well as from the demand sides. In such conditions the pound could be confidently expected to float up as often as to float down; and there is no reason why in such circumstances a floating pound should not continue to be used as an international currency.

But what would be the use of a country's international reserves of gold and foreign-exchange in such a system, in which its currency was allowed freely to find its own level in the foreign-exchange markets? The foreign-exchange markets, though in general free, might be subject to the intervention of the exchange equalisation account or similar authority of each member country, the authority selling some of its reserves of foreign-exchange

for its own domestic currency to mitigate what it considered an unreasonable speculation against its currency, or *vice versa*. Cushioned in this way by the use of a country's reserves, the necessary fluctuations in a country's exchange rate could be taken at a very moderate speed.

Such a system is, of course, open to misuse if the authority in one country attempts to manipulate the exchange rate between its currency and the currencies of its partners to obtain some commercial or other advantage which its balance-of-payments position does not really need. Partly to avoid this danger and partly to provide greater liquidity for European countries there might be instituted a European Monetary Fund into which each member would pay an amount of its own national currency. This fund would be under some form of independent "supranational" management of a technical banking character; and its management would be empowered on its own initiative to buy and sell the currencies in the fund to ease the balance-of-payments adjustments of the members. This fund would also provide a forum at which the policies of the fund itself and of the national exchange equalisation funds could be continuously discussed and integrated. To avoid speculation such integration would, of course, have to take the form of secret discussions between the central monetary authorities of the member countries. Such a system would be capable of almost indefinite development. As an integrated Europe became more and more of a reality, so the member States could pay greater and greater sums of their own currencies into the European Fund and could start also to pay into it part of their reserves of gold and dollars as well, until finally the supranational fund had superseded the national exchange equalisation funds. And as their domestic financial policies became more and more harmonised and integrated, so smaller and smaller fluctuations in exchange-rates need be permitted, until finally the conditions for what I have called the integration approach to the balance-of-payments problems have been fully met and exchange-rate variations can be abandoned.

The proposals which I have just made are, of course, riddled with difficulties and imperfections. I put them forward only as a challenge to others to produce something which is simpler, but equally effective, for dealing with European balances of payments without preventing European free trade or destroying European full employment.

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